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Management disclosure and earnings management practices in reducing the implication risk

Normah Omar ^{a*} Rashidah Abdul Rahman ^b Bello Lawal Danbatta ^c and Saliza Sulaiman ^{d*}

^{a*, b & c} Accounting Research Institute (ARI) and ^d Faculty of Accountancy,
Universiti Teknologi MARA (UiTM) 40450 Shah Alam, Selangor, Malaysia.

Abstract

This paper examines two types of earnings management practices, the techniques employed, the motives behind the practices and the likely good, bad or ugly implications of each. The examination and analysis of this study indicates that earnings management practices based on manager's personal motives is the ugliest with the worst negative implication. However, the result of the analysis had provided insight that improved disclosure by both managers and management will reduce the risk of bad or ugly practices. It also provided an insight for future research on the implications of various motives behind earning management practices highlighted in the paper.

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1. Introduction

Although earnings management (EM) is permitted by the Generally Accepted Accounting Principles (GAAP) in most jurisdictions, but the motives behind its practices and the techniques employed by most managers makes its practices always suspicious. Conceptually, it is a strong management tool that is used to improve the welfare of the company's stakeholders if ethically used in line with the provisions of the GAAP. Depending on its motive, earnings

* Corresponding author. Tel.: +0-000-000-0000 ; fax: +0-000-000-0000 .
E-mail address: normah645@salam.uitm.edu.my

management practices can have several implications on the company's share price and its going concern. While some of the implications are good for the company, others are bad and very ugly as they may result in total winding-up of the company. The problem here is that, this ideal management tool is always linked to manipulations of earnings and fraudulent financial reporting practices like creative accounting and income smoothing; as a result there have been arguments among researchers as to whether earnings management is good or bad. However, this may not always be the case because it is almost impossible in today's dynamic and challenging business environment to find a company that does not practice earnings management since it is allowed. Contemporarily, there are two key types of earnings management namely; accrual earnings management (AEM) and real earnings management (REM) and each of these have its backing of the GAAP. So, making a general assumption that earning management is always a fraudulent activity is a wrong judgement that affects firms negatively, the focus should rather be on the motives behind the techniques used and the likely outcome of the practice. Another problem that this paper want to address is answering the question of "how do we determine good, bad or ugly earnings management practices?", as from almost all of the earnings management literatures reviewed, there are none which have addressed this question so far in the same perspective as this current study is approaching the topic. Hence, the main objective of this paper is to examine and analyse the key earning management practices with special focus on the techniques employed, the incentives and motives behind the practices and the likely good, bad or ugly implications of the practices for the purpose of enhancing regulatory and management control in the use of the concept using a particular model. It is also expected that, this paper will improve the general technical understanding and perception of the GAAP's permissibility of earnings management practices as well as the understanding that fraudulent financial reporting has more to do with corporate governance issues rather than the earnings management concept. To achieve these objectives, these practices are attempted to be classified into the good, the bad and the ugly practices. Regardless of the fact that the literatures reviewed for this study are not the ones which attempted to classify these practices into the stated classes, the definition of the good, the bad and the ugly earning management practices are attempted to be clarified in this paper.

EM leads to a gamut of consequences. At the organisational level, firms may manage earnings to enhance their credibility, increase their stock price, reduce political and social costs, etc. At the individual level, executives can alter their compensation plans to their favour, increase values of their stock options, enhance their reputation, etc. However, if EM is perceived as unethical by financial statement users, then managers' and companies' reputations negatively get affected and companies' credibility in the market is damaged. There are also further negative effects too like high litigation costs, decrease in stock prices, heightened regulatory scrutiny, loss of reputation, etc., which in themselves should be effective to restrain manager to practice EM, Siddharth Mohapatra (2011).

2. Literature Review

To achieve the objectives of this paper, some of the fundamentals in EM concepts are reviewed and highlighted, but as mentioned earlier, no previous literature that are reviewed and referred to have approached the topic in the same perspective which is intended to be analyze for this particular study.

2.1 Definition and Types of Earnings Management

Healy and Wahlen (1999) define earnings management as the use of managers' judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers. Magrath and Weld (2002) describe that earnings management practices is designed either to assist managers in fulfilling their obligations to stakeholders or to deceive investors. Whatever the motives are, intentionally or unintentionally, earnings management to one extent provides deceiving reports to users. Firms who intentionally produced deceiving reports with regards to their earnings or delay in producing the current report to reflect their current earnings lead users of financial statement to make wrong decision.

Fraud firms are those who managed earnings previously (Perols and Lougee, 2011). Those firms who prepare misleading financial statement will be accused as committing financial statement fraud. Similar to those firms who delay in submitting their reports on timely basis as violating the continuing listing obligations under chapter 8 of Listing Requirement of Bursa Malaysia, 2012. Most fraud firms used accounting earnings management to manage their

earnings. Matsuura (2008) divides earnings management into accruals earnings management and real earnings management. In this study the focus of the discussions and analysis will be only on accruals earnings management and real earnings management practices in Malaysia.

Accruals earnings management is discretionary portion of accruals. Accounting fundamentals used to separate accruals into non-discretionary (normal) and discretionary (abnormal) accruals. Non-discretionary accruals are those accruals which are derived from normal firms' business activities or past accounting transactions that are recorded in the books but have yet to be realized. Some mandatory expenses or assets fall under this category as well. Examples of non-discretionary accruals are payroll taxes payable, any upcoming bills and obligatory expenses that have yet to be realized but already recorded in the firms' accounting records. They are usually not exposed to earnings management techniques. *Real earnings management* on the other hand, is a proxy variable for discretionary cash flow. Similar to discretionary accruals, discretionary cash flow from operations derived from the variance between actual cash flow and normal cash flow. The normal cash flow model is developed by Dechow, Sloan and Sweeney (1998) and implemented by Roychowdhury (2006). Roychowdhury (2006) defines real earnings management as departures from normal operational practices with the primary objective of meeting short-term earnings goals. This is motivated by managers' desire to mislead at least some stakeholders into believing certain short-term financial reporting goals have been met in the normal course of operations. These activities are less likely to be challenged by regulators on purely business decision and for realizing short-term benefit. In realising the short-term goals, the repercussions of real earnings management have cost impact on future cash flows.

2.2 Earning Management Techniques and Motives

Earnings management is a very popular term used by management to manage earnings. But it does not simply refer to any illegal activities by management to manage earnings. Managers can achieve earnings from accounting choices or by operating decisions. Managers can manage earnings because they have flexibility in making accounting or operating choices (Md. Musfiqur, Mohammad Moniruzzaman and Md. Jamil Sharif, 2013). There are many techniques in earning management, but the most common and popular are twelve (12) as highlighted by most researchers as follows:

- i. *Big Bath technique*: a technique used when a company had some losses or charges due to operations restructuring, troubled debt restructuring, asset impairment and written-down, discontinued operation of a segment or subsidiary and they want to get rid of it all at once in current or particular period. This technique is based on the belief that if the management want to report a bad news of losses, it is better to report it all at once and get it out of its way.
- ii. *Big Bet for the Future technique*: a technique commonly used after acquiring another company. It involves management's judgment in writing-off of the Research and Development cost as well as integrating the earnings of the acquired company into the consolidated results of the parent.
- iii. *Changing the GAAP technique*: this involves management judgment in volunteering for a new accounting standard, changing revenue and or expenses recognition rules. For example changing depreciation method from reducing balance to straight line method.
- iv. *Cookie Jar Reserve technique*: this involves manager's judgment in creating financial slack by over estimating future expenses with the hope that actual future expenses will be lower than the provisions thereby creating a reserve that they can tap and boost their future performance. It is commonly used in estimating sales revenue, warranty cost, bad debt write-offs, pension expenses, etc.
- v. *Depreciation, Amortization and Depletion (DAD) technique*: this involves management's discretionary judgment in selecting the write-off methods and periods, changing the estimation methods of salvage values or change of asset class or use. For example from operating to non-operating or vice versa.
- vi. *Early Retirement of Debt technique*: this technique involves manager's judgment in selection the accounting period to retire debts for the purpose of utilizing any gain or loss on early retirement. It includes retirement of long term bond issued by corporate, debt for debt swaps and or debt for equity swaps.
- vii. *Flushing the Asset Portfolio technique*: most GAAPs requires investments to classified either as held for trading or available for sale and any change in value is recorded in the income statement. This technique involves manager's judgment in deciding the holding intent, timing of sales and written down of impaired investments.

viii. *Operating Vs Non-operating Income technique*: managers new that investors and financial analyst uses core (operating) earnings of the company to project future growth not the non-operating income, so this technique involves use of management's judgment in identifying and reporting items that are operating or non-operating. For example, items like un-usual or special charges, extraordinary gains or losses, etc.

ix. *Sales or Leaseback and Asset Exchange technique*: this technique involves management decision on outright sales of assets to get more revenue in certain periods, sale and leaseback of same asset to get some revenue and exchange of similar productive assets without recognition of any gain or loss.

x. *Shrink the Ship technique*: this technique involves company repurchasing its own shares without reporting and gain or loss in their financial statement, because the key objective of this technique in most cases is to increase the company's earnings per share.

xi. *Throw Out a Problem Child technique*: this technique involves manager's judgment to dispose a subsidiary when the group's earning are dragged down by non or less performing subsidiary for purpose of saving or improving the group's financial results and actions taken may include; outright disposal of the subsidiary, spinning off the subsidiary, creating a special-purpose entity (SPE) for financial asset and equity exchange.

xii. *Use of Derivatives technique*: as derivatives are financial instruments that derived their values from other assets, managers uses them as techniques to manage their earning by hedging against future business risks like fluctuations in exchange rates, prices changes and commodity scarcity.

Although all of the above techniques are permitted by the GAAP in most countries, but the issue always remains on the motives behind the employment or use of a particular technique in a particular accounting period. The motives or reasons behind the use of one technique or a combination of techniques are diverse and depends on the interest of the individual manager or the entire management. Recent studies like that of Md.Musfiquer et al. (2013) and many others, highlighted the under listed reasons as the key incentives behind the use of most of the above mentioned techniques:

- i. Stock market motives
- ii. Motivations to signaling or concealing of private information
- iii. Political motivations
- iv. Personal interest motives
- v. Company Internal motives e.g. changes of CEO
- vi. Taxation Motivations,
- vii. Management (Bonuses) compensation motivations;
- viii. Lending contracts motivations
- ix. Other contractual motivations and
- x. Regulatory motivations

2.3 Earnings Management and Fraudulent Financial Reporting

Having defined earnings management and highlighted the various earnings management techniques and motives, it is important to clarify the meaning of fraud and fraudulent financial reporting. KPMG Malaysia Fraud Survey (2009) define fraud as a deliberate deceit planned and executed with the intent to deprive another of property or rights directly or indirectly, regardless of whether the perpetrator benefits for his/her actions. And Statement of Auditing Standards (SAS) No.99, issued by Auditing Standard Board (ASB) of the AICPA in November 2002 defines fraudulent financial reporting as: "intentional misstatements or omission of amounts of disclosures in the financial statements designed to deceive financial statement users". Based on these definitions, financial statement fraud may be perceived as violation of any accounting and auditing standards, laws and regulations enforced by any relevant reporting bodies anywhere, on certain facts or figures, intentionally committed the wrong doings in that particular period with the purpose to deceive the users of the financial statements and many of today's largest frauds are committed by intelligent, experienced, creative people with a solid grasp of firms' controls and vulnerabilities.

Perols and Lougee (2011) find that fraud significantly higher for firms that have previously managed earnings. Zhou and Kapoor (2012) reveal that managers will not resort in various value destroying activities (earnings management or fraudulent financial reporting) if there is less pressure. Apart from this fraud risk factor, earnings management arises from agency frictions, serve as an incentive for managers to engage in such manipulation in order to maximize their

compensation at the expense of shareholders value. Possibly when managers indulge more to manage firms' earnings to maximize their private benefits, the situation providing pressures to them and later serve them with no choice but to commit fraud. Common methods of fraudulent financial statement manipulation include recording fictitious revenues, concealing liabilities or expenses and artificially inflating reported assets (ACFE Report, 2010). According to Kranacher, Riley and Wells (2011), when showing strong earnings is needed, there can be tremendous temptation to classify expenses as assets and liabilities as equity.

3. Methodology

This paper is focused on earnings management practices with some evidences from firms in Malaysia that were alleged to have committed financial statement fraud and it is aimed at highlighting the implications of these practices based on the three classifications and types of earnings management and the techniques employed. The methodology to achieve this objective include gathering and analyzing of secondary financial data on the companies involved, review of industry reports, review of previous studies on the topic as well as performing descriptive analysis on the earnings management practices from ethical or corporate governance perspective. The main source of the secondary financial data of companies is their financial reports published in their respective websites, Thomson DataStream database and Osiris database. However, although the paper is descriptive in nature but the evidences discussed are based on past empirical studies all data collected were processed using SPSS.

3.1 Earnings Management Detecting Techniques

A number of literatures have suggested many ways and methods of detecting earnings management practices and it is the results of technique used that will indicate whether a practices is good, bad or ugly based on the degree of manipulation or adjustments. However, the followings are the most popular earnings management detecting techniques:

1. Using aggregate or total accruals
2. Through specific accruals
3. Through cost allocation or cost shifting
4. Through disclosures
5. Through examination and or auditing of real activities

Majority of studies uses aggregate accruals to detect EM. They mostly use the Jones (1991) model to: estimate expected accruals, compare those with actual accruals and use the difference as a proxy for detecting earnings management. Nevertheless, there are also other studies using: specific accruals, cost allocation or cost shifting, disclosures and 'real action' to detect earnings management; the first three refer to altering financial data and the last refers to the (re)structuring transactions in order to increase/decrease reported earnings (Siddharth Mohapatra, 2011).

Having known that EM can be detected using aggregate accruals and examination of real activities, for the purpose of this study, it was decided that the financial data that collected on these 49 firms in Malaysia that were alleged to have committed financial reporting fraud and delisted from the Malaysian Stock Exchange (Bursa Malaysia) is processed as evidences for bad and ugly EM practices.

4. Analysis and Discussions

As mentioned in the preceding sections of this paper, no models or literatures that classifies earnings management practices into the three ethical classes namely; the good, the bad and the ugly practices were found upon the development of this study. The approach of this topic is originated by the researchers' own approach. It is the researchers' own contribution towards making a cautious correction of the practices rather than just being critics of the practices without providing remedy and the objective of this paper is provide us with additional appropriate evidences on bad and ugly practices of EM especially with regards to accrual earnings management which is a proxy variable for discretionary accruals and real earnings management which is a proxy variable for discretionary cash flows. In most of the literatures reviewed, researchers indicated that real earnings management is less vulnerable to fraud when compared

to accrual earnings management and more in-line with the provisions of most GAAP but having a positive relationship between the two will indicate that a firm is somewhat fraudulent in their EM.

4.1 The Good, the Bad and the Ugly Practices

Even though earning management is permitted by GAAP in most jurisdictions, but the impact of its practices differs from company to company. Earnings management practices are said to be good if and only if, they are ethically executed by managers and they can among other things; improve the share price of the firm, enable the firm to source future funds or financing, improve the welfare of all stakeholders, promote investor confidence, ensure improved quality of financial reporting, improved the level of reliance that can be placed on the firm's financial information, enable the firm to achieve reliable and predictable financial results as well as to ensure stable going concern of the firm without violating any prudential regulatory requirements. The good earnings management may have nothing or very little to do with fraudulent financial reporting.

On the other hand, earning management practices are said to be bad if and only if they are ethically executed by the managers but they did not resulted in much good for the firm due to the high level of unethical motives behind the techniques employed or due to conflict interest in the overall practice. Bad earnings management practice is an earning management that is executed by managers to serve one specific objective of managers, the firm shareholders or other purpose like meeting loan covenants. Bad earnings management does not necessarily result in the overall goodness for the company. The motives may or may not be aimed at fraudulent financial reporting. An earning management practice is said to be an ugly practice if it is unethically executed by managers regardless of whether they resulted in something good or bad to the firm either at short or long term. It is an earnings management practices that is manipulative by its nature and it is aimed to deceive either one class of stakeholders or the entire public. It may serve its purpose in a short run but the outcome of its impact at the long run is very severe. Its impact may usually result in company losing its share price, being delisted from the stock market or even being winded-up.

4.2 Evidences of EM Practices

Table 1 below highlighted the results of the hypothesis testing on the relationship between AEM and REM among these 49 alleged fraudulent firms at three different periods in order to detect their practices. Technically, three hypotheses were tested, but for the purpose of this paper, the reported result is one; H1, which test whether positive relationship exist between accruals earnings management and real earnings management among the alleged firms after adjustment for control variables namely percentage of inside directors (% INSD), auditors' type (AUDITYPE) and return on assets (ROA). The regression analysis model employed in this study has a total of five variables. The regression equations are as per below:

$$\text{Period 1:} \quad \text{AEM} = \beta_0 (\text{Constant}) + \beta_1 \text{REMit} + \beta_2 \% \text{ INSDit} + \beta_3 \text{AUDITYPEit} + \beta_4 \text{ROAit} + \epsilon_{it} \quad (1)$$

$$\text{Period 2:} \quad \text{Pre_AEM} = \beta_0 (\text{Constant}) + \beta_1 \text{Pre_REMit} + \beta_2 \text{Pre_}\% \text{ INSDit} + \beta_3 \text{Pre_AUDITYPEit} + \beta_4 \text{Pre_ROAit} + \epsilon_{it} \quad (2)$$

$$\text{Period 3:} \quad \text{Post_AEM} = \beta_0 (\text{Constant}) + \beta_1 \text{Post_REMit} + \beta_2 \text{Post_}\% \text{ INSDit} + \beta_3 \text{Post_AUDITYPEit} + \beta_4 \text{Post_ROAit} + \epsilon_{it} \quad (3)$$

Where:

AEM is discretionary accruals as estimated by Kothari et al. (2005)'s model.

Pre_AEM is accruals earnings management (AEM) for three years prior to fraud year (t-3, t-2, t-1)

Post_AEM is AEM for alleged fraud year and immediately subsequent to fraud year.

REM is discretionary cash flow from operations as estimated by Roychowdhury (2006)'s model.

Pre_REM is real earnings management (REM) for three years prior to fraud year (t-3, t-2, t-1)

Post_REM is REM for fraud year and immediately subsequent to fraud year.

% INSD is a variable for the percentage of inside directors.

AUDITYPE is a dummy variable equal to "1" if auditor was a Big 4 audit firms and "0" otherwise.

ROA is net income over current year total assets.

ϵ_{it} is the regression residual indicates proxy variable for AEM or Pre_AEM or Post_AEM.

The results is consistent with H1, suggesting that those firms who were alleged to have committed fraud decreased their AEM practices and opt for REM because it is perceived that REM are less traceable by auditors and regulators mainly because the activities are of real operational basis even it does sacrifice the firms' future cash flows as reported by many researchers like Zhou and Kapoor (2012). This is consistent with the findings in this study whereby the coefficient of ROA is positive (0.458) and statistically very significant at 1 percent level, suggesting that when firms manage their earnings based on accruals earnings management upwards, it is smoothen by real earnings management practices, the net income stabilized or increases, ultimately increased the net income of the firms. The result of the study indicates the increase in return on assets of the fraud firms consistent with the increased in accruals earnings management and the negative relationship with the REM. The adjusted R Square for this model is 0.153 indicates that REM, % INSD, AUDITYPE and ROA explains about 15.3 percent of the variation in accruals earnings management. This is consistent with adjusted R square in the local studies by Abdul Rahman and Mohamed Ali (2006) with 12.8 percent of its independent variables explaining the relationship between earnings management and top 100 firms in Malaysia. From the regression result, the findings indicate that there is a significant negative relationship between accruals earnings management and real earnings management. Hence, H1 is accepted.

Table 1. Hypothesis testing results

	Across the years		Prior to Alleged Year		Alleged to Post Alleged Year	
	(2001 - 2011)		(t-3, t-2 & t-1)		(t0 until t+1)	
	Coefficients	t - Statistics	Coefficients	t -Statistics	Coefficients	t – Statistics
Intercept	-0.031	-1.426	-0.041		-1.835	-0.374
REM	-0.358	-3.729***	-0.45	-4.762***	-0.231	-1.155
INSD	0.06	1.194	0.046	0.875	0.067	0.708
AUDITYPE	0.008	0.514	0.015	0.954	-0.005	-0.156
ROA	0.458	5.729***	0.859	8.070***	0.29	2.257**
Multiple R	0.411		0.623		0.266	
R-Square	0.169		0.388		0.071	
Adjusted Square	R 0.153		0.369		0.024	
F Value	10.737 ***		20.158***		1.504	
N	216		128		84	

***Significant at the 0.01 level

**Significant at the 0.05 level

Substituting the above results in the regression models the followings estimates are formulated;

$$\text{Period 1: AEM} = -0.031 - 0.358 \text{ REM}_{it} + 0.060 \% \text{ INSD}_{it} + 0.008 \text{ AUDITYPE}_{it} + 0.458 \text{ ROA}_{it} + \epsilon_{it}$$

$$\text{Period 2: Pre_AEM} = -0.041 - 0.450 \text{ Pre_REM}_{it} + 0.046 \text{ Pre_}\% \text{ INSD}_{it} + 0.015 \text{ Pre_AUDITYPE}_{it} + 0.859 \text{ Pre_ROA}_{it} + \epsilon_{it}$$

$$\text{Period 3: Post_AEM} = -0.015 - 0.231 \text{ Post_REM}_{it} + 0.067 \text{ Post_}\% \text{ INSD}_{it} - 0.005 \text{ Post_AUDITYPE}_{it} + 0.290 \text{ Post_ROA}_{it} + \epsilon_{it}$$

Some of the earning management practices that fall within GAAP are: (a) choice of accounting methods (like, straight line versus reducing balancing depreciation, LIFO versus FIFO valuation of inventory, interpreting consignment sales as ordinary sales, deciding on the useful life of fixed assets), (b) accruals estimation (e.g., understate and/or overstate provisions), (c) real transactions (like, overproductions; timing the R&D expenditures, SG&A, maintenance expenditures; timing of assets disposals). Some examples of earnings management that are considered to violate GAAP and hence fraudulent are: recording fictitious sales, early recognition of sales, backdating sales invoices, recording fictitious inventory and fabricating false invoices to boost sales figures, Siddharth Mohapatra (2011). Hence, EM practice is good when it is ethically undertaken in the accordance with the provisions of the GAAP and when;

1. it is used to unblock communications between firm and its stakeholders,
2. firm's operating environment is volatile and there is a lot of insider information and
3. There is a rational and efficient market expectation.

Therefore, any EM practice outside the above framework is either bad or ugly. However, to reduce the impact of bad EM practice managements or managers should improve their disclosure on; adopted accounting policies, major discretionary accruals, the effects of write-offs on core earnings as well as disclosing any bad earning management technique previously adopted at the board meetings for discussions with the board of directors and shareholders in order to mitigate the future impacts of bad EA practice. Because improved disclosure will not only make it easier in assessing the management's stewardship but it will also improve share prices to reflect the true firms value, promote good corporate governance as well as improve firm's social responsibility.

5. Conclusion

Concluding whether earnings management (EM) is a good, bad or ugly accounting practice is dependent on the ethical commitment of the firm's management and its managers in using the right EM technique at the right period without compromising all other stakeholders interest for their own interest. But the concept in its real provisions by most GAAP is an excellent tool for management to align their financial activities for the purpose of improving the welfare of their stakeholders and there are many steps and techniques in detecting EM practices before drawing conclusions as to whether the practices is good, bad or ugly. So, it is unfair to just conclude that EM is bad or good, care need to be exercised in examining the practices. Regulators, auditors, financial analyst and other users of financial statements should familiarize themselves with all EM techniques as well as the EM detecting techniques. To remedy bad EM practices, managers and management need to improve their disclosures EM practices to all relevant stakeholders. Reading this paper will raise so many questions on the EM practices and theory which future researches need to provide the answers.

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